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Italian Banking Foundation Proposed Reforms: Safer Shareholders Make Safer Banks

On 11 March 2015, the Italian Association of Banking Foundations (ACRI) approved a memorandum of understanding prepared by the Italian government, proposing changes to the foundation's governance and financial practices. According to the agreement, adhering foundations will have to:

- diversify their asset portfolios and not to rely on a few single investments for their income. A quantitative limit of 33.3% for each single investment is set;
- avoid the use of leverage in the *fondazione* in principle, although an exception is possible in short-term limited liquidity needs;
- avoid the use of derivative instruments unless with the aim of hedging other exposures and with no risk to the foundation's capital.

The governance related reforms pertain mainly to management compensation, including quantitative limits, board composition and transparency.

From a credit-rating perspective, Scope believes that this is a positive development. As highlighted in our bank rating methodology we look at governance and ownership structure as key factors in the assignment of our ratings. In Italy, the peculiar relationship between banks and banking foundations has historical reasons, and at times may have acted to steer bank management decisions in a questionable direction. For example, considerations regarding dilution of a financially stretched shareholder may act to unduly delay a much needed capital increase. Asset concentration at the foundations may limit managerial flexibility with regards to dividend distributions, as foundations effectively rely on the participated bank's dividend stream to fulfil their social goals.

We highlight that a decline in the influence of the core *fondazioni* at rated banks Intesa (BBB+, Positive outlook) and Unicredit (BBB, Positive outlook) would in our view be positive as it would reduce the risk of politicised business decisions and also increase managerial autonomy.

The stricter limits to the use of leverage and derivatives positively impacts the financial health of the *fondazioni* themselves, which in turns increases the ability of the banks to raise capital in times of need.

Scope's understanding is that the reforms will have to be approved by the individual foundations in the coming weeks, and that foundations will then have three years to conform to the new rules.

We believe the agreement is a sound and welcome further step in the reform of the Italian banking system, following the recent proposed reform of *Popolari* banks (see our **report** from January 2015). We note that in this case the reform proposals are the result of a negotiation between the government and the foundations themselves and as such we expect less push-back from the industry. Having confronted the two major areas of contention with respect to governance, we believe the banking reform agenda in Italy will now likely shift towards lowering the length and cost of contract enforcement which would help address the abnormally high level of impaired loans, which a key weakness of the Italian banking sector.

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